Market failures and MNEs

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Classification: economics and strategy; foundations; multinational enterprise/international business

Definition

Market "failures" is a viable (although partial) explanation for foreign direct investment. Foreign investment requires multinational activity, so a theory of FDI, is also a theory of MNE. Contractual complexities resulting in high transaction costs, and stemming from the need to transfer intangible assets or the requirement to pioneer new markets will raise the possibility of "market failure" which can be resolved through the internalization of overseas activity within the MNE.

Abstract

Anticipating complex transactional issues, which are tantamount to market failures, managers will choose to bring economic activity inside the firm. This in turn requires foreign direct investment in partially or wholly owned subsidiary companies. There are at least three types of market failures that relate to the existence and structure of multinational enterprises. The first occurs when transaction costs are high relative to the administrative costs of organizing an activity internally. A second type of market failure concerns the relative inefficiency of markets for the transfer of certain types of resources, such as knowledge and capabilities. In a third case, markets don't exist at all until individuals exercise entrepreneurship and deploy resources to create or co-create them.

Keywords: entrepreneurship, foreign direct investment, internalization, market creation, multinational enterprise, organizational capabilities, resource transfer, transaction costs, market imperfection, knowledge, transfer, transaction costs, capabilities, asset orchestration, integration.

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Market failures

Kindlegerger (1969:14) proposed taxonomy of market failures, consisting of imperfections in goods markets, imperfections in factor markets, and imperfections flowing from scale economies and government-imposed disruptions such as tariffs and controls on international capital. Some authors distinguish two kinds of market imperfections: structural and transactional (Dunning, 1981; Dunning & Rugman, 1985). The former refers to market imperfections relating to industry structure (e.g. oligopolistic industries) while the latter emphasizes Coase or Williamsonian type market "failure."

Market failures may exist when a market is non-existent or underdeveloped (i.e. the governance of economic activities in the market is inefficient) and refers in the MNE context to contractual difficulties and attendant high transaction costs in the operation of markets for intermediate goods (Williamson, 1971) and for technology and knowhow (Teece, 1981a; 1986). Market imperfections, can be thought of as departures fromperfect competition, or as impediments to the simple interaction of supply and demand to set a market price (Rugman, 1981:41). Market failures occur due to the coupling of two environmental conditions –uncertainty and the small number of market participants, along with opportunism and bounded rationality, which leads to exposure to re-contracting hazards (Williamson, 1975; 1985).

The existence of the MNE

Market "imperfections" of the Coase-Williamson kind are of particular relevance in explaining the rise of the MNE. Perhaps Hymer was the first to apply elements of the Coase-Williamson paradigm, noting in one place that the MNE is a "practical institutional device which substitutes for the market" (1976:48). However, most of the time he had a more classical view of market imperfections (in line with Kindleberger) and emphasized product and factor market departures from perfect competition. He argued that control of a foreign subsidiary is "desired in order to remove competition between that foreign enterprise and enterprises in other countries...or to appropriate fully the returns on certain skills and abilities (p. 25). These advantages provide market power, which Hymer believed explained the existence of the MNE. In other words, the MNE could use its subsidiaries to produce goods similar to those in the home country by making use of the information internal to the MNE, thus giving it an advantage over other local firms in foreign operations.

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Clearly, Hymer's analyses relied more on structural imperfections, which are essentially Bain-type product and factor market imperfections (which somehow get leveraged advantageously by the MNE) rather than Coase-Williamson type transaction costs. The distinction is useful for analyzing efficiency implications of the MNE. The tension between market power and efficiency aspect of the MNE was first explored in Teece (1981a). If market failures are structural, and are associated with (antitrust) market power, then the MNE as a monopolistic rent seeking its actions are not necessarily "efficient" (Dunning & Rugman, 1985). However, if the market "failures" the MNE overcomes are inherent in the nature of business, then the MNE is solving a fundamental problem in the economic system, and ought to be lauded (Teece, 1981a). Multinational investment and growth can then be seen as efficiently and productively enhancing.

The internalization approach

Scholars highlighting the latter type of market "imperfections" have developed the transaction cost approach to the theory of the MNE, which has become known as the internalization theory. It was Coase who first recognized that "the operation of a market costs something" and that the internal organization of a firm can be an efficient method of production (1937, p.338). The substitution of internal organization for market exchange is referred to as internalization. Buckley and Casson (1976) were the first to give wide currency to this set of ideas.

In their seminal 1976 book, The Future of Multinational Enterprise, Buckley and Casson applied Coasian economics to the MNE, implicitly shifting the dominant conceptual model of the MNE from market power to market failure. According to this model, modern businesses carry out a range of activities, including marketing and R&D that are inter-related through flows of intermediate products such as knowledge and expertise (Buckley & Casson, 1976:33). Absent the MNE, these transactions might not take place at all, or would be more complex and difficult to manage.

Many MNEs are vertically and (or) horizontally integrated. With vertically integrated MNEs, the MNE operates its own supply chain across borders.

The emergence of vertical foreign investment can be traced to the sourcing of intermediate goods and raw materials, such as oil and copper (Vernon, 1971). If such markets were well developed and functioning, there would be few circumstances where internalizing markets produce efficiencies (Teece, 1981). However, entrepreneurial activities are often needed to get markets started. This is what the MNE supplies.

One should class assets where it is clear that organizing things contractually are as complex as intangible assets, including know how.

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Given that intermediate product markets for intangible assets like knowhow are difficult to organize, MNEs often choose to transfer knowhow internally, using common control and ownership, better control over the technology and ensuring its efficient transfer

Caves (1971) linked the failure of knowledge market with the emergence of the MNE, suggesting that the MNE engages in product differentiation and horizontal integration as a response to market failure and extends its monopoly firm specific advantage into global markets. Cave's view was consistent with the early Hymer view that some product market imperfections (market power) are the raison d'etre of the MNE. In our view, he failed to understand the efficiencies associated with technology transfer across borders inside the MNE.

Transactional market failure is often country-specific, and thus it influences the locational decisions of MNEs (Dunning & Rugman, 1985). Thus, MNEs can be referred to as "internalizing exogenous spatial imperfections" (Rugman, 1981). Structural market distortions, such as government intervention, facilitate or discourage inward direct investment of MNEs, while MNE activities can occur irrespective of locations if there are transactional market failures (Dunning, 1988). In such conditions, MNEs benefit from arbitrage opportunities and better coordination by internalizing these markets (Kogut, 1985).

Since the creation of an internal market by the MNE is not costless, the advantages from internalization must be sufficient to offset the additional costs of operating abroad. This is what Hymer (1976) reffered to as the "liability of foreignness." Rugman (1980) and many others accepted this basic premise.

Firms internalize markets until the cost of further internalization outweighs the benefits (Coase, 1937; Buckley, 1983:42). The "failure" in the market for intermediate goods is viewed as both a necessary and sufficient condition to explain the rise of MNEs (Buckley & Casson, 1985).

In short, the transaction cost perspective described above has been applied to the international context by a wide variety of scholars, including Buckley and Casson (1976), Dunning (1981), Hennart (1982), Rugman (1981), Teece (1981), and Williamson (1981). Foreign direct investment is efficient because when contracting with independent agents to effectuate the same goals would be expected to lead to costly future problems. Thus, if an overseas activity involves investing in transaction-specific assets that cannot readily be redeployed to other uses, then an overseas contractor making the dedicated investment would be exposed to the likelihood of future unfavorable renegotiation. The market "fails" in this case because the prospective overseas contractor might refuse to enter into a contract, or might demand such generous terms that internalization is clearly more profitable.

Resource transfers and market failure

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A different form of market failure has been less extensively developed in the literature. It involves resource transfer costs and learning issues, which are better captured by the capabilities view of the MNE rather than as transaction costs.

At the heart of the Williamsonian transaction cost approach is the notion of non-redeployable assets. Investments in such assets render arm's-length contractors vulnerable to opportunism. The resource transfer view looks at another kind of transaction cost and also looks beyond costs to capability development.

Overseas resource transfers between independent parties are inherently more complex and costly to contract for and to execute than transfers between two parts of the same firm (Teece, 1976). This is particularly true of intangible resources, which are also among the most valuable, in a strategic sense, that a firm is likely to possess. These include technology, know-how, market knowledge, managerial skills, and brand image. When the recipient of the transfer is a separate company bound only by a contract, the quality of communication is likely to be lower and the actions taken by the recipient harder to monitor than for an internal transfer.

Internal transfers of resources and subsequent learning from their new context are facilitated by well-developed administrative procedures and the common (organizational) culture of the enterprise. This leads to the ease of coordination inside the firm relative to coordination through the market. Within a single company, worries about the leakage of valuable knowledge are also mitigated and future benefits from experiential learning will be captured by the firm itself. Internalization also simplifies the interchange of personnel across borders, which is often a necessary accompaniment to resource transfers, because most resources involve some degree of tacit knowledge.

Resource transfer is a process, not an isolated event. When this process takes place between two parts of a single organization, the possibility of learning is greater than when two separate companies are involved. The market falls short ("fails") in this case because it is difficult, if not impossible, for one firm to reap the benefits of learning that takes place within a second firm.

The resource transfer view has given rise to a knowledge-based view of the MNE. In this view, the expansion of the enterprise requires the creation of new knowledge as part of an ongoing, social process that reflects the firm's unique history and resource set (Kogut & Zander, 1993). Learning and other forms of knowledge creation are a wellspring of organizational capabilities.

market co-creation and the capabilities approach

The transaction cost approach recognizes that markets sometimes fail to be the efficient form of organization relative to internal organization ("integration" or "internalization"). This paradigm ignores

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the need for market creation and co-creation, which have always been fundamental activities of the MNE.

In many cases, markets may not yet exist for innovative products and services, or for products and services that exist in one country but have not yet been marketed overseas. In a fundamental sense, this is a market failure. The assumption often adopted in economic theory is that markets always exist. In reality, markets often need to be created by a firm, or co-created by a network of firms. Market creation requires the action of entrepreneurial managers shaping demand and assembling the complements needed for new markets to be viable (Pitelis and Teece, 2010; Teece, 2014).

In the early stages of developing an overseas market, internalization is likely to be the more efficient and effective form of organization. In the case of selling a new product, for example, local firms may not be competent to provide the necessary customer education. Over time, as the market becomes established, local suppliers of marketing services may develop an understanding of the product or service to the point that they would be suitable contracting partners.

Teece (2014) argues that the market failure postulate is only an analytic convenience. As noted in the last section, it is often the case that a market hasn't emerged yet and needs to be (co) created by entrepreneurially managed MNEs. MNEs' market creation functions are ignored in the TCE based explanations. Hence, the dynamic capabilities-based entrepreneurial theory of the MNE… which recognizes the importance of market creation and asset orchestration… complements the contract-based perspectives it addresses MNEs' entrepreneurial activities such as creating and deploying resources along with market co-creation. Together these help explain the reasons for differential performance across MNEs.

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